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Cases and Authorities Cited.

Supreme Court of the United States

October Term, 1941.

No. 1186

MODERN FACTORS COMPANY,

Petitioner,

vs.

TASTYEAST, INC.,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI.

BRIEF IN OPPOSITION TO PETITION.

Facts.

The petitioners seek a writ of *certiorari* to review a judgment of the Circuit Court of Appeals, Third Circuit, which holds that the provisions of a promissory note and a chattel mortgage securing the same, purporting to obligate the maker to pay interest at 2½% per month after maturity, constituted a penalty and was therefore unenforceable in a bankruptcy court.

On March 25, 1940, the petitioners Louis J. Singer and Jacob Singer, doing business under the trade name of Modern Factors Company, held a promissory note of Tastyeast Inc., on which the principal sum of $27,000 was due and unpaid. The petitioners then advanced to the

respondent "an additional loan" of $6,600 and took a renewal note for $33,600, secured by a chattel mortgage upon respondent's corporate assets. Both the note and mortgage contained the following provisions respecting the payment of principal and interest:

> "* * * commencing April 8th, 1940 and each and every two weeks thereafter, consecutively, the sum of $400.00, without interest, up to September 25th, 1940, at which time the unpaid balance shall become due and payable; *from and after September 25th, 1940 interest on said unpaid balance shall be paid at the rate of 2½% per month*" (Appendix Below, p. 8).

Neither the note nor the mortgage contained any other provision for payment of principal or interest.

On June 25, 1940, the respondent filed a petition for reorganization under Chapter X of the Bankruptcy Act. At that date five payments of $400 each had been made on account of principal, thus reducing the loan to $31,600.

From this so-called "additional loan" the petitioners retained the sum of $3,600, declaring that "the mortgagee, with the consent of the mortgagor is being repaid the sum of $3,600 in payment of appraisal fees, service and finance charges and other expenses incurred in making this loan" (Appendix Below, p. 9). The fact is that $3,600 of the "additional loan" was retained by the petitioners and never paid to the respondent. This sum included interest at the rate of 20% per annum (10% for six months) on the total principal of the note and mortgage, plus $240 for "other expenses" alleged to have been incurred in connection with the renewal of the loan. It was admitted throughout the proceeding below that interest at the rate of 20% per annum on $33,600 was paid in advance. The interest thus paid in advance was computed on the principal of the note and mortgage and no refund or allowance was made in favor of the respondent. The interest so re-

tained was approximately 21% of the principal actually outstanding.

The respondent was adjudged insolvent, but no adjudication of bankruptcy was made.

On September 25, 1940, the maturity date, default was made in the payment of principal. The assets of the respondent were then in possession of, and being administered by the bankruptcy court in reorganization proceedings.

After the adjudication of insolvency, a Plan of Reorganization was proposed by the debtor, which, after certain amendments and changes, provided for payment to the petitioners of the principal of $31,600, together with interest thereon after the date of maturity, *at a rate to be determined by the court* on approval of the Reorganization Plan (Appendix Below, p. 10). That Plan also provided among other things, that a new corporation should be organized under the laws of New Jersey, to be called "Tastyeast, Inc.", to which all the property and assets of the debtor corporation should be transferred; that the new corporation should issue preferred and common stock; that all general creditors should receive $1.00 par value of the preferred stock of the new corporation for each $4.00 of indebtedness; that "such preferred shares when issued * * * shall constitute payment in full and a discharge of all claims and interest of general creditors against the debtor". (10 (a) Order Confirming Altered Plan, etc., Appendix Below, p. 4).

For the purpose of fixing the rate of interest to be paid subsequent to maturity, the debtor moved before the Referee to fix the rate of interest subsequent to maturity, at a reasonable rate, and not more than 6% per annum. The Referee overruled this motion and in his report recommended that the interest rate be fixed at 2½% per month on the unpaid principal of $31,600 from the maturity date. September 25, 1940.

Thereafter, the District Court Judge confirmed the Referee's report and ordered the respondent to pay the petitioners the principal of \$31,600, plus interest from September 25, 1940, at the rate of 2½% per month to the date of payment.

In the Order Confirming the Altered Plan, the court granted leave to the respondent to appeal from so much of its determination as awarded petitioner's interest in excess of ½% per month, or 6% per annum (Appendix Below, bottom p. 5), *on condition* that pending the appeal (a) the petitioners be paid the principal sum of \$31,600, plus interest thereon at the rate of 6% per annum from September 25, 1940, to the date of payment (Subsection III (a) Appendix Below, p. 5); (b) that the respondent deposit with the Clerk of the United States District Court for the District of New Jersey a sum equal to 2% per month on the principal sum of \$31,600 from September 25, 1940 to the date of deposit (Appendix Below, p. 6); (c) that the respondent file a cost bond or deposit cash in the amount of \$250 in lieu thereof, with the Clerk of said Court; (d) that the debtor deposit with the Clerk of said Court an additional sum of \$250 in cash to cover interest charges at 6% per annum on the sum of item (b) from the date of deposit to the date of the determination of the appeal.

Pursuant to that order the respondent has deposited cash in the sum of \$5,645.87, being the amount of increased interest in dispute, together with the sum of \$500 to cover the above items (c) and (d). Said amounts still remain on deposit with the Clerk of said Court.

The sole ground on which a writ of *certiorari* is sought is the alleged error of the Circuit Court of Appeals in reversing the order of the District Court insofar as it awarded to the petitioners additional interest at the rate of 2% per month, to be computed on the sum of \$31,600 from September 25, 1940.

ARGUMENT

I.

The provisions of the note and mortgage requiring payment of interest at the rate of $2\frac{1}{2}\%$ per month, constitutes a penalty and is unenforceable in bankruptcy court.

In *Story's Equity Jurisprudence, 14th Ed. Vol. 3, § 1726,* in discussing the origin of the doctrine that equity will not enforce a penalty, the author says:

> "But whatever may be the origin of the doctrine, it has been for a great length of time established and is now expanded so as to embrace a variety of cases not only where money is to be paid but where other things are to be done and other objects are contracted for. In short, the general principle now adopted is that wherever a penalty is inserted merely to secure the performance or enjoyment of a collateral object, the latter is considered as the principal intent of the instrument, and the penalty is deemed only as accessory, and therefore as intended only to secure the due performance thereof or the damage really incurred by the non-performance. In every such case the true test (generally if not universally) by which to ascertain whether relief can or cannot be had in equity is to consider whether compensation can be made or not. If it cannot be made, then Courts of Equity will not interfere. If it can be made, then if the penalty is to secure the mere payment of money, Courts of Equity will relieve the party upon paying the principal and interest."

And in *§ 1732,* the author says:

> "In the next place in regard to cases of forfeitures. It is a universal rule in equity never to en-

> force either a penalty or a forfeiture. Therefore Courts of Equity will never aid in the devesting of an estate for a breach of a covenant on a condition subsequent, although they will often interfere to prevent the devesting of an estate for a breach of a covenant or condition."

In *Van Buren* v. *Digges*, 11 How. 460, Digges agreed to build for Van Buren a house and have the same completed and ready for occupancy by December 25, 1844. Digges agreed to forfeit 10% of the whole amount if the house should not be entirely completed for occupancy on the date specified in the contract.

Van Buren failed to pay the contract price and Digges brought suit. The defendant set up various defenses, among them that the house was not completed on December 25, and that he was entitled to a deduction of 10% of the entire amount because of this breach of contract. The Court said (p. 476):

> "* * * The clause of the contract providing for the forfeiture of ten per centum on the amount of the contract price, upon failure to complete the work by a given day, cannot properly be regarded as an agreement or settlement of liquidated damages. The term 'forfeiture' imports a penalty; it has no necessary or natural connection with the measure or degree of injury which may result from a breach of contract, or from an imperfect performance. It implies an absolute infliction, regardless of the nature and extent of the causes by which it is superinduced. Unless, therefore, it shall have been expressly adopted and declared by the parties to be a measure of injury or compensation, it is never taken as such by courts of justice, who leave it to be enforced where this can be done in its real character, viz: that of a penalty."

In *United Shoe Machinery Co.* v. *Abbott,* 158 Fed. 762 (C. C. A. 8), the Court recognizes the rule here contended for and said, page 764:

> "A contract by a debtor to pay an amount in excess of lawful interest in the event of his default in the payment when due of a simple contract debt is a contract for a penalty, against public policy, and unenforceable".

In Re Merwin & Willoughby Co., 206 Fed. 116 (U. S. Dis. C. Northern Dis. of N. Y.), the claimant leased to Merwin & Willoughby Co. a store service system for ten years. The lease provided that in case of breach by the lessee, or its bankruptcy, the rent for the entire term of ten years should become immediately due, and that after breach the lessor might re-enter and thereby terminate all rights and interest of the lessee.

About a year after the service was installed, the lessee became bankrupt and it was then in default. The Receiver used the system until he sold the store, and paid rent for that time. The lessor filed a claim for rent for the entire remainder of the term. The Court held that the terms of the lease constituted a penalty and that the claim was unconscionable, and would not be allowed against the bankrupt estate, citing *United States Shoe Machinery Co.* v. *Abbott,* 158 Fed. 762.

In discussing Penalties & Forfeitures in Williston on Contracts, Revised Edition, Volume 3, Sec. 784, the author says:

> "It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach."

> *Citing, Clydebank Engineering etc. Co.* vs. *Castaneda, A. C. 6.*

In Vol. 21 *Corpus Juris* 99, Sec. 71 Equity—Penalties and Forfeitures—under the caption Increased Rate of Interest, it is said:

> "A familiar application of this doctrine, where the contract is one for the payment of money, is where it is provided that a higher rate of interest shall be paid unless the debt is paid upon its maturity. This provision is treated as a penalty and equity forbids the enforcement of the higher rate."

Usury and Penalty are distinct defenses to the enforceability of a contract. Because an agreement is not usurious, it does not necessarily follow that it may not involve a penalty. This distinction is illustrated in In re *Liberty Doll Co. Inc.*, 242 Fed. 695, where the Court construed a provision in a contract which purported to give rise to a claim of $2500 for commissions due the claimant for services rendered to the bankrupt under a contract. It was held, that while the contract was not usurious, because the bankrupt, being a corporation, could not plead usury, under the State law, it was nevertheless unconscionable, and the provision complained of was in the nature of a penalty. In disposing of this feature of the case, the Court said:

> "Undoubtedly, as between private individuals, the provision of the ninth paragraph would be void for usury, because the obligation to pay, irrespective of service rendered, clearly would make the $2,500 a bonus for a loan. As against this bankrupt corporation, the provision is certainly in the nature of a penalty. Two rules are well established: (1) That where the sum agreed upon is so great as to be unconscionable, it will be regarded as a penalty; (2) that where the stipulated amount is disproportionate to presumable and possible damages, or to a readily

ascertainable loss, the courts will treat it as a penalty."

In determining the validity of a claim in Bankruptcy the Court construed a provision in a contract in the case *In re Gelino's, Inc.*, reported in 43 F. (2nd) 832 (certiorari denied 284 U. S. 659; 76 L. Ed. 558) and decided that it amounted to a claim for a penalty and limited the recovery to the actual damages sustained. In following the rule stated in *In re Liberty Doll Co., supra*, the Court said:

> "Where the sum named in a contract to be paid on a breech is wholly disproportunate to the actual damages sustained, the Court will deem the parties to have intended to stipulate for a mere penalty to secure performance, and not for a liquidation of damages".

In holding that the provisions of the note and mortgage involved in the present case constituted a penalty, the Circuit Court of Appeals followed the well established rule enunciated by the foregoing authorities. Judge Clark is clearly justified in stating:

> "We fail to find any direct relation between the increased rate and the anticipated loss which a default might have caused the mortgagee. Rather it seems to us that the mortgagee definitely intended to enforce a penalty upon the debtor. The inequality in their bargaining positions is evident since the mortgagee was able to extract a prepaid interest of approximately 21%. The debtor's overpowering economic need induced it to undertake the risk of the huge increase in interest and the possibility that it would be liable for 30% interest upon its unpaid 21% interest. As we view the transaction, both parties knew the increase was intended only to coerce the debtor into a prompt payment upon maturity. As such it was an agreement for a penalty and unenforceable in bankruptcy."

II.

The cases cited by petitioners are not applicable to the question of penalty.

Counsel for the petitioners cites numerous cases which deal with the question of usury and liquidated damages. We do not find among them any authorities applicable to contracts which provide for the enforcement of a penalty. They are therefore not in point.

The case of *Ramsay* v. *Morrison*, 39 N. J. L. 591, is cited as supporting petitioners' contention that the contract in question is not illegal.

The legality of that contract was attacked because it was claimed to be usurious. On that point the Court said (p. 593):

> "The contract is not usurious. This being the only point raised, the plaintiff is entitled to judgment upon the report, and the rule is discharged."

III.

The decision of the Circuit Court of Appeals does not impair any right of petitioners under the federal constitution, or otherwise.

The petitioners complain that their contract rights have been impaired. They build up that claim on the contention that the contract is not usurious. The respondent is not attacking the contract as usurious, but as one imposing a penalty. That being the case, the contract does not impose a legal obligation upon respondent to pay 30% interest. Hence, under it the petitioners are entitled only to the dam-

ages which they have sustained, but the damages suffered by the petitioners for failure to pay money on the due date, is the lawful rate of interest. This has already been paid to the petitioners, and they have thereby received full compensation for respondent's failure to pay on the due date.

In *United States Shoe Machinery Co.* v. *Abbott*, 158 Fed. 762, the Court said, at page 763:

> "Legal interest is the measure of damages for the failure to pay debts when they are due, and hence a contract to pay an amount in excess of such interest on account of a default in the payment of money when it is due is an agreement for a penalty which the courts will not enforce."

There was no error in the decision of the Circuit Court of Appeals and the application for a writ of certiorari should be denied.

Respectfully submitted,

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